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Weekly Highlights
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- The GOA more than doubles gas export tax to 45 percent.
- President Kirchner announces that unemployment decreased to 10.4 percent in Q2 of 2006.
- The GOA successfully auctions USD 500 million in Bonar V bond.
- Banco Nacion withdraws dollars from BCRA for GOA's debt payments.
- Argentina and Brazil will no longer use the dollar as commercial exchange currency.
- Government Confidence Index down 6 percent m-o-m in July.
- Commentary of the Week: "Reelection, 'Concertacisn' and Investment"

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The GOA more than doubles gas export tax to 45 percent.
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¶1. On July 25, the GOA raised the gas export tax from 20 percent to 45 percent. The GOA decided to increase levies on exports to mitigate the effect of the price agreement reached with Bolivia, which increased the price of imported natural gas from USD 3.20 to USD 5 per million cubic meters through the end of the year. According to Argentine Planning Minister Julio de Vido, the price of natural gas exported to Chile will remain below USD 4 per million cubic meters, which is still well above the present range of USD 1.7 - USD 2.5 per million cubic meters. Chile buys 90 percent of Argentina's gas exports. Chilean officials were surprised by the announcement because although the price will be below the USD 5 paid by Argentina to Bolivia, it will still be higher than what Argentine Planning Minister Julio De Vido originally told them.

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President Kirchner announces that unemployment fell to 10.4 percent in Q2 of 2006.
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¶2. On July 27, President Nestor Kirchner announced that preliminary figures indicate the unemployment rate decreased to 10.4 percent in the second quarter of 2006 -- compared to 11.4 percent in the first quarter of 2006 and 12.1 percent in the second quarter of 2005. The GOA projects that unemployment will be below 10 percent by the end of the year.

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The GOA successfully auctions USD 500 million in Bonar V bonds.
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¶3. On July 26, the GOA sold USD 500 million in Bonar V bonds (a five-year, dollar-denominated bond) at a 8.34 percent yield, in line with the Ministry of Economy's goal to achieve a yield lower than 8.5 percent. This issuance will enable the GOA's to pay USD 2.3 billion owed on Boden 2012 and 2007 capital dues, to be paid by August 3. This was the GOA's third Bonar V auction, and it received bids for USD 2.5 billion (five times the auctioned amount), completing the USD 1.5 billion issuance scheduled for this year.

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Banco Nacion withdraws dollars from BCRA for GOA debt payments.
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¶4. On July 12, Banco Nacion started withdrawing dollars deposited in the BCRA to send to the Argentine Treasury, which is in charge of paying the Boden 2012 and 2007 capital dues on August 3. Between July 12 and 18, Banco Nacion withdrew USD 360 million, and local analysts estimate that the amount reached USD 450 million by July ¶21. This money is part of the fiscal surplus deposited in the BCRA, and it is expected that the GOA will have USD 1.2 billion by August ¶3. According to local media, the decision to making daily withdrawals is to smooth the fall in the reserves at the beginning of August, avoiding an increase in volatility.

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Argentina and Brazil will no longer use the dollar as commercial exchange currency.
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¶5. On July 24, Argentine and Brazilian Economic Ministers Felisa

Miceli and Guido Mantega agreed to start using their local currencies in commercial transactions with each other (Argentina-Brazil commerce is currently worth ARP 15 billion a year). Until now, each country purchased dollars to buy exports, while in the future both countries will operate in Argentinean pesos and in Brazilian reales. This will be accomplished by the creation of a bank that will handle both countries' transactions. In addition, the ministers agreed on a joint proposal that requests a new line of contingency credits with fewer requirements and a redistribution of power within the IMF, which they will present at the IMF's annual meeting in Singapore this September.

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Government Confidence Index down 6 percent m-o-m in July.
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¶6. The Government Confidence Index decreased 6 percent m-o-m in July to 2.53 points, 0.06 below the average during the Kirchner administration and well above the 1.2-point level in May 2003 when Kirchner took office. Confidence in the GOA's ability to solve citizens' problems is still the factor generating the most confidence and the only one that increased in July (+1 percent m-o-m). Public opinion of the GOA's general performance, honesty of GOA officials and efficiency of public spending decreased 4 percent, 12 percent and 11 percent m-o-m, respectively. The index rose 22 percent y-o-y. [The Government Confidence Index is a survey-based index prepared by Di Tella University. It varies from zero to five points and seeks to measure public opinion of GOA's general performance, efficiency of public spending, honesty of GOA officials and the government's ability to solve problems.]

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The BCRA raises reserve requirements on checking and saving accounts from 17 percent to 19 percent.
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¶7. The BCRA announced that reserve requirements on demand deposits would increase from 17 percent to 19 percent and that peso-denominated, fixed-term deposits for 180 days or more would no longer be subject to reserve requirements. These measures will be effective as of August 1. The BCRA also announced that banks' cash holdings will no longer count toward reserve requirements, a signal

that the banking system has returned to normal. (The BCRA allowed banks to count cash holdings toward reserve requirements during the 2001 economic crisis.) The BCRA hopes this measure, which will be implemented in September, will increase the average term of bank deposits and promote lending.

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The BCRA increases its participation in the repo market.
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¶8. The BCRA began to operate in the dollars repo market this year, but in the past four months its participation was negligible. Since last week, however, it has begun increasing operations; from July 17 to July 21, the BCRA made average active repo operations of USD 100 million a day with financial companies. This change came about because the BCRA aims to smooth over the loss of due to the Boden 2012 and 2007 capital dues payments, due by August 3.

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The GOA signs agreement with pasta producers to freeze prices.
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¶9. On July 25, the GOA announced an agreement with pasta producers to freeze prices at their June 30 levels. The GOA has negotiated several price agreements with different food producers as part of its strategy to control inflation through voluntary price agreements in various sectors. Secretary of Internal Trade Guillermo Moreno is now analyzing prices in bars and restaurants, as that is one of the sectors that are putting the most pressure on last month's inflation figures.

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The GOA provides cattle plan in response to rancher strike.
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¶10. On July 24, the GOA announced a plan to increase cattle production and the supply of beef in order to meet local and foreign

demand, and to improve information quality and commercial transparency in the meat market. The plan was launched a day before the ranchers' strike was scheduled to end. Ranchers were angered with the GOA beef exports ban that, according to the strikers, has cost them newly won foreign markets. The plan will allocate ARP 857 million over the next four years to activities such as technology and pasture improvement, sanitation and reproduction plans, and others. The plan will also provide subsidized loans.

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Fiduciary funds will be included in the 2007 budget.
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¶11. According to the Fiscal Responsibility Law, the GOA must include fiduciary funds and funding for other governmental offices in the 2007 budget. Up until this year, these funds were allocated independent of the budget. This legislation will affect approximately ARP 4.2 billion of the current 16 fiduciary funds and ARP 7.1 billion in funding for government institutions like the Fiscal Authority (AFIP) and PAMI, the GOA social security agency.

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Mercosur will add a productive policy advisor to deal with trade asymmetries.
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¶12. One concrete decision reached at last week's Mercosur summit is the addition of a productive policy advisor to deal with trade asymmetries. The measure responds to the complaints from the block's smallest members, Paraguay and Uruguay, regarding asymmetries in trade between their economies and Argentina and Brazil. Paraguay has even threatened to leave Mercosur. This advisor will attempt to create an industrial integration strategy that will promote mutually beneficial relationships instead of competition between the countries.

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Argentina proposes "Bank of the South," to be headquartered in Argentina
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¶13. At last week's Mercosur summit, Argentina presented a proposal for a "Bank of the South" (also called the Mercosur Development Bank), which would be headquartered in Argentina. The proposed bank would finance investment projects and hold part of the regional banks' reserves. The proposal will be considered by Mercosur members in the coming months. Under the plan, member countries would provide a portion of the initial funding, with stake sales to other countries providing the rest. The aim of this project is to strengthen the relationship between Mercosur member countries in areas such as production, technology, commerce and financing of public and private investments.

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June trade surplus of USD 957 million comes in above expectations.
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¶14. The June trade surplus reached USD 957 million, above market expectations of USD 781 million. Exports increased 12 percent y-o-y to USD 3.8 billion, following 13 percent y-o-y growth in May, with increases in both price (+8 percent) and quantity (+4 percent). Exports were driven by increases in industrial goods (+30 percent y-o-y), fuel and energy (+13 percent y-o-y) and agro-industrial products (+4 percent y-o-y), while primary goods remained unchanged. Imports increased 5 percent y-o-y to USD 2.9 billion, with increases in both price (+4 percent) and quantity (+1 percent). Imports were driven by increases in passenger vehicles (+22 percent), consumer goods (+22 percent), accessories for capital goods (+11 percent), fuel and oil (+8 percent) and intermediate goods (+8 percent), as well as a decrease in capital goods (-12 percent). The accumulated trade surplus reached USD 5.9 billion during first half of 2006 and according to the BCRA consensus survey, it is expected to narrow to USD 10 billion by the end of the year, compared with USD 11.3 billion in 2005.

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BCRA rolls over its maturities. Investors keep concentrating their bids in Nobacs.
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¶15. The BCRA received ARP 849 million in bids at its July 25 Lebac and Nobac auction, and no Lebacs or Nobacs came due during the week. It accepted ARP 87 million in Lebac bids and ARP 439 million in Nobac bids. The yield on the 182-day Lebac was 8.80 percent and in the 266-day Lebac was 10.70 percent. Lebacs with a maturity of one year was withdrawn because of the BCRA's decision to not validate the yield proposed by the market, and Lebacs for maturities of more than 366 days where withdrawn due to lack of interest. The spread on the one-year Nobac remained at 2.08 percent, and the two-year Nobac spread decreased from 3.78 percent to 3.74 percent. The Badlar rate (the base rate for Nobacs) is currently at 9.3 percent.

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The BCRA will report only on reserves stock until August 3.
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¶16. For the first time since Martin Redrado became president of the BCRA, the institution will report only on the stock level of reserves, not on daily transactions in the dollar market. Until August 3, the BCRA will purchase dollars on behalf of the Argentine Treasury in order to make the Boden 2012 and 2007 capital dues payments. For that period, the Ministry of the Economy, not the BCRA, will have the right to decide whether to make information on daily transactions public.

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The peso is unchanged against the USD this week, closing at 3.10 ARP/USD.
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¶17. The peso remained flat versus the USD this week, closing at 3.10 ARP/USD. As mentioned above, the BCRA will not report daily transactions in the dollar market until August 3. The peso exchange rate has depreciated 1.6 percent since the beginning of the calendar year. The BCRA's reserves stood at USD 26.2 billion as of July 21, and have increased USD 7.6 billion, or 41 percent, since the GOA

prepaid its entire IMF debt on January 2.

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Economic Minister Miceli praises the BCRA's exchange rate policy.
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¶18. On July 25, Economic Minister Felisa Miceli defended BCRA's exchange rate policy, calling it "pro-production," and maintained that without BCRA's dollars purchases, the exchange rate would likely be between 2.2-2.4 ARP/USD. She also said that this exchange rate has allowed local industries to be competitive and profitable.

¶19. On the other hand, the IMF reported that the dollar is 10 percent-15 percent overvalued against the peso, suggesting a 2.7 ARP/USD peso exchange rate would be more accurate. The IMF's conclusion arises from a more extensive real exchange rate analysis.

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Commentary of the Week: "Reelection, 'Concertacisn' and Investment", by Luciano Laspina, Economist and Director of MacroVisisn Consultants, from an article published in El Cronista on June 9.
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¶20. The electoral race has begun and it will continue marking the course of economic policy. Who could doubt it? Fiscal expansion and price agreements are inseparable partners in the electoral scene for 2007.

¶21. Perhaps for that reason, fiscal policy is demonstrating a clear acceleration in spending since the beginning of 2006. Primary expenditures grew at an average rate of 31 percent this year. Discretionary spending (excluding automatic transfers to provinces) grew even more strongly (34 percent) compared to a growth of 23.5 percent in 2005. Although the trend of decreasing public saving (as a percent of GDP) began with the 2005 electoral cycle, the first months of 2006 not only failed to reverse the trend, but made it stronger.

¶22. Although there is no risk from the point of view of solvency, the natural consequence of this expansionary trend in fiscal policy

is to increase inflationary pressures. Does this mean that this year's inflation will be higher than the 12.3 percent of 2005? Not necessarily. There is a growing difference between observed inflation and underlying inflation (the inflation of those goods and services that are not distorted by regulations, controls and/or price agreements). Our predicted rate of observed inflation (CPI) is around 12 percent (though it could be even lower). Underlying inflation, however, already exceeds 16 percent annually. This difference is explained by the impact of price agreements that keep down inflation: it should be remembered that currently 58 percent of the subcategories that make up the Consumer Price Index are being distorted by regulations, controls and/or agreements.

¶23. Political analysts appear to forget that the experience of "concertacisn" (agreement) - a word that has become popular again with the Kirchner administration - has its nearest predecessor, geographically speaking, not in Chile but in Argentina from 1973-1974, initiated during the administration of Hector Campora and continued (with some modifications and resonant exclusions) during the third administration of Juan Peron. This strategy of "concertacisn," which was later derived in the "Social Pact" and popularized as the "Gelbard Plan," had as its primary economic objective a reduction in inflation (which was around 70 percent annually in the first months of 1973 and was exacerbated by a fiscal deficit that averaged 6 percent of GDP between 1973 and 1974), and as its social and political objective an improvement in income distribution. One of the most prominent characteristics of the "concertacisn" that later came out of the Social Pact of 1973-74 was the tripartite negotiation between government, businessmen, and unions to modify the regressive trend of income distribution, by which they fixed prices, salaries and tariffs.

¶24. It is not sensible to compare current circumstances with the macroeconomic dynamic that preceded the failure of the Gelbard Plan, an experience of agreements and controls of prices and wages that ended in an inflationary explosion. But it is indeed worrisome that

the current program faces some of the microeconomic deficiencies that the previous situation found: private investment did not respond sufficiently to accompany the expansion of demand.

¶25. The economic and political reasons for the failure of the Gelbard Plan go beyond our purposes. It is enough to say that many factors are not present in the current context: the inconsistency between fiscal, monetary and exchange policy combined with price controls that aimed for the explicit goal of "zero inflation" (as Guillermo Moreno has now begun to suggest) drove a scenario of extremely high repressed inflation, a lagged exchange rate and finally a explosion of deflation. Today, the fiscal position is expansionary but not causing a deficit, the monetary emission responds to the purchases of reserves by the BCRA and not to the financing of the fiscal deficit and/or of the disequilibrium in the banking system. And the exchange rate, other than the short-term volatility, is the exact opposite of that scenario: the panorama today appears more like one of "undervalued currency" than the opposite. These reasons are more than sufficient to avoid linearly extrapolating the scenario of 1973-74 (which culminated with the "Rodrigazo" of 1975) to the experience of "price agreements" and eventual "concertacisn" of 2006-07.

¶26. The variable to monitor is the investment rate. Without significant fiscal or monetary disturbances, like those that dominated the macroeconomic dynamic back then, investment could be the variable that receives the impact of price agreements/controls. So the great mystery to solve today is the response of supply (including the already legendary output-gap in the discussion) to sustained growing demand.

¶27. The goal of re-election has begun to influence economic policy. Although there remains much time chronologically, politically the October 2007 election is close. The world is not a "bed of roses" right now, but neither does one observe an alarming shift. The year could end with a growth rate around 7.5 percent and an inflation rate around (and perhaps under) 12 percent. It's not a bad scenario, but it hides considerable microeconomic weaknesses and an excessively unorthodox anti-inflationary strategy. (Note: We reproduce selected articles by local experts for the benefit of our readers. The opinions expressed are those of the authors, not of the Embassy. End Note.)

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